Impact of Board Heterogeneity Composition on Firm Risk: An Empirical Study

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ABSTRACT

There has been scant research exploring the implications of board heterogeneity for board’s functioning and subsequent corporate outcome of stability in firm performance. A number of hypotheses are developed based on a multi-theoretic approach incorporating board resources, board dynamics, and board independence. Results of testing the hypotheses reveal that board heterogeneity in organizational tenure, functional experience, and educational specialty is related to the stability of returns. Furthermore, increased ownership position by directors and institutional investors strengthens the relationship between board heterogeneity and stability of returns. The results of this study suggest that board heterogeneity increases organizational rationality and further the stability in firm performance through its more effective control and counsel functions to management.

Keywords: Board Equity Ownership, Board Heterogeneity, Firm Performance, Institutional Ownership Concentration, Stability in Firm Performance

INTRODUCTION

Organizational risk has important implications for executives, shareholders, suppliers, and employees (Bromiley, 1991; Shapira, 1995; Sanders & Hambrick, 2007). Performance volatility not only hinders organizational planning activities but also increases chance of corporate decline and mortality by diminishing firm’s ability to respond to critical changes in the external environment (Palmer & Wiseman, 1999). Stability in firm performance, on the other hand, is often viewed as indicative of executive capability to environmental changes. Lower organizational risk (e.g., stability in corporate income streams) would be reflective of firm capability in predicting environmental changes, maintaining firm-environment alignment, and developing sustainable competitive advantages (Miles & Snow, 1978). In the face of relentless global competition and accelerating technological change, income stability allows a firm to buffer its core from extreme environmental fluctuations.

Board of directors has the final authority to assess and approve all major risk-related organizational decisions such as mergers and acquisitions, consolidation, and the reorganization of subsidiaries. Each of these decisions involves...
considerable risk for the organization because changes in market domains and technologies have outcomes that are not easy to predict.

A growing body of research in recent years has examined the implications of board heterogeneity for organizational outcomes such as corporate strategic change (Haynes & Hillman, 2010; Goodstein et al., 1994), board’s internal dynamics (Westphal & Bednar, 2005), and board engagement in the discussion of entrepreneurial issues (Tuggle et al., 2010). Unfortunately, board researchers and practicing managers know little about how board heterogeneity is related to the organizational risk through its functioning.

Research on the impacts of board heterogeneity on board’s controlling and counseling functions require a multi-theoretic approach. This is because board performance is the outcome of a number of factors such as board resources, board internal dynamics, and economic behavior of directors. In recent years, corporate governance researchers have emphasized the need for integrative theoretical approaches in revealing subtle mechanisms among governance constituents (Hillman & Dalziel, 2003; Devers et al., 2008; Haynes & Hillman, 2010; Deutsch et al., 2010). For instance, Hillman and Dalziel (2003) argued that board independence may not be a sufficient condition for board effectiveness in control function over management; rather board independence should be understood together with a board’s capability.

Recent research focusing on the behavioral agency model (BAM) argues for the incorporation of a behavioral perspective into the elements of traditional one principal-one agent situations (Deutsch et al., 2010: 221). In this regard, heterogeneity of directors—as a source for diversity in a board’s human capital and cognitive behavior—should have substantial implications for the board’s functioning and therefore on subsequent corporate outcomes such as organizational risk (reflected in this study as performance volatility).

From a resource dependence perspective, it has been argued that greater variety of human capital through heterogeneous composition of boards would lead to a wider range of information, experience, and expertise in a board (Cannella et al., 2008; Carpenter et al., 2004; Finkelstein & Hambrick, 1996). From a group dynamics perspective, heterogeneity in board members’ cognitive backgrounds should affect their interpersonal behaviors hampering the formation of conformity in a group (Pelled et al., 1999; Li & Hambrick, 2005), which would facilitate board independence in thoughts and actions.

It may be harder for a CEO to dominate a board whose members have diverse cognitive orientations and behaviors rather than a board with cognitive homogeneity which inevitably leads to group cohesion and conformity. That is, a board’s expanded informational base and independence derived from its heterogeneous composition increases its decision comprehensiveness and rationality. This in turn should enhance the stability in firm performance through effective control and advisory functions of the board. Additionally, from an agency theory perspective, equity ownership with the firm should have impact on the board members’ engagement in monitoring, controlling, and counseling functions over management (Jensen & Meckling, 1976).

In order to explore the implications of board heterogeneity for organizational risk, this study develops a multi-theoretic model that draws from the theoretical underpinnings of resource dependence, board group dynamics, and the agency-theoretic perspectives. We empirically examined the association between board heterogeneity and the volatility of returns using a sample of 298 Fortune 1000 firms.

The results of testing a number of hypotheses developed from a multi-theoretic model support the argument that board heterogeneity is negatively related to volatility of returns. Moreover, the relationship becomes stronger when the board members have higher firm equity ownership. The results of this study highlight the importance of using a multi-theoretic approach in exploring the role of board heterogeneity. Our results suggest that board heterogeneity increases board effectiveness in controlling and advisory roles, which in turn enhances organizational rationality leading to lower levels of performance fluctuation.
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